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Dr. Hamed Hassan Merah

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Dear Dr. Merah,

السلام عليكم ورحمة الله وبركاته،،

**CIBAFI Comments on the AAOIFI Exposure Draft on Auditing Standard no.6 for
Islamic Financial Institutions: External Shariah Audit**

The General Council for Islamic Banks and Financial Institutions (CIBAFI) compliments the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) and takes this opportunity to express its appreciation of the work that the AAOIFI does to promote and enhance the Islamic financial services industry (IFSI).

CIBAFI is the official umbrella for all Islamic financial institutions, whose services and products comply with the Shariah rules and principles. CIBAFI acts as the voice of the Islamic finance industry, where our members comprise Islamic banks and non-bank financial institutions, both large and small, and reach more than 120 members from 32 countries and jurisdictions.

We would like to express our thanks to the AAOIFI for its great effort and commitment with respect to developing standards that accommodate the interest of the global Islamic

finance industry. We noted the request for comments on the AAOIFI's Exposure Draft (ED) on Auditing Standard for Islamic Financial Institutions No. 6: External Shariah Audit (Independent Assurance Engagement on an Islamic Financial Institution's Compliance with Shariah Principles and Rules) and we welcome this opportunity to offer our comments and recommendations. The comments contained in this letter represent the views of CIBAFI Secretariat and feedback received from our members. We are also attaching other comments in the Appendix of this letter for AAOIFI's kind consideration.

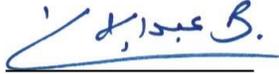
Firstly, the reference point in this standard is International Standard on Assurance Engagements (ISAE) 3000. However, the standard does not refer to any of other AAOIFI auditing standards unlike the previous AAOIFI auditing standards, which make reference to the audit standards approved by AAOIFI for IFIs (ASIFIs). This seems to undermine the previous work of AAOIFI, and may pose the question about the framework of other auditing standards.

Secondly, the ED establishes a hierarchy of standards which auditors must apply. AAOIFI standards come at the top, two places ahead of rulings by the Shariah board of the jurisdiction. CIBAFI perceives that the adoption of this standard in any jurisdiction would therefore automatically apply to all AAOIFI Shariah standards in the jurisdiction, and ahead of any national standards, which might not be appropriate for many jurisdictions and may hamper the adoption and implementation of the whole standard. In addition, this seems to contradict other AAOIFI standards that make the Shariah Supervisory Board of the Islamic financial institution as the reference point for the institution.

Thirdly, the ED suggested for Islamic Financial Institutions (IFIs) to implement the standard effective 1st January 2018. CIBAFI believes the proposed time is not enough to do so, especially as the standard will not be issued immediately. In addition, the ED is currently only provided in English language for public commentary. CIBAFI emphasises the need for having the ED issued in Arabic language to increase the number of banks' responses and to engage more interested parties including the Shariah scholars.

We remain at your disposal should you need any further clarifications on the above or on the attached appendix.

Yours sincerely,



Abdelilah Belatik
Secretary General

Appendix

Comments on the Exposure Draft of the “Auditing Standard for Islamic Financial Institutions No. 6. - External Shariah Audit (Independent Assurance Engagement on an Islamic Financial Institution’s Compliance with Shariah Principles and Rules)”

1. Relationship with other AAOIFI and professional standards

The existing AAOIFI auditing standard ASIFI 4 is entitled “Testing for Compliance with Shariah Rules and Principles by an External Auditor”. It is unclear whether the new standard is intended to replace this standard, in whole or in part and there are some important inconsistencies between the two, some of which are mentioned below.

The ED says that the standard is to be read in the conjunction with the International Standard on Assurance Engagements (ISAE) 3000, “Assurance Engagements Other than Audits or Reviews of Historical Financial Information”, and the requirements of ISAE 3000 shall apply if there is no contradiction with the requirements of this standard or inconsistencies with Shariah (para 2 and 3). However, The ED is silent on the relationship with other AAOIFI standards that cover similar areas addressed in this ED.

2. Scope of the standard

The ED in para 4 indicates that the external Shariah Audits conducted by independent practitioners, who might be the external auditor, in this case, will be issuing a consolidated / joint report, or separate reports. There will be possibility of overlap between the duties of external Shariah auditor and external auditor. CIBAFI believes that in this case more elaboration and details shall be provided.

3. Definitions

The existing auditing standard ASIFI 4 states (para 7) that the external auditor shall be knowledgeable about Islamic Shariah rules and principles. This ED defines the external

Shariah auditor as: “a practitioner being a professional accountant in public practice who, at the request of the IFI, provides an independent assurance report on the state of compliance by an IFI with the Shariah principles and rules” (para 8. d). It thus requires the auditor to be an accountant. This raises two important issues. First, this removes the possibility of having external Shariah audit performed by specialized Shariah advisory firms, which is already the case in some jurisdictions. And second, the ED does not impose any requirement for knowledge in Shariah matters to the professional accountant. Though, there is a requirement for “adequate resource and capability” at firm level in para 11. CIBAFI therefore suggests the revision of this paragraph and add more clarifications about the background and qualifications of External Shariah Auditor. It is important that AAOIFI clarifies that the external Shariah auditor should have Shariah and Islamic finance knowledge to be able to give a proper opinion on compliance of financial arrangements, contract, and transactions from Shariah perspective.

The ED (para 5) indicates that the external Shariah audit might take the form of direct external Shariah audit, or an attestation external Shariah audit (covering the statement of Shariah compliance which some regulators require the IFI’s management to provide). The standard then gives three different definitions of direct external Shariah audit, attestation external Shariah audit and external Shariah audit (para 8. a, b, and c). The third of these concepts is simply the sum of the other two, and it might be better if the definition reflects this directly.

4. Shariah Supervisor(s)

The ED (para. 12) indicates that “The external Shariah auditor shall also determine the Shariah supervisor(s) of the IFI with whom it may need to interact, communicate with, request Fatawa, rulings and specific opinions from, including on the observations identified. Normally an IFI’s Shariah Supervisory Board, or equivalent, or their nominee shall be the person(s) suitable for this purpose, unless, the structure or regulations have mandated other Shariah supervisor(s) in place”.

A conflict of interest might be appearing in the case of assigning an internal Shariah supervisor from same audited institution (including members of SSB). In addition, it is

not clear how the external Shariah auditor determine the Shariah supervisors. Does the External Shariah auditor has this right within its duties and responsibilities? Therefore, it is recommended to have an external Shariah auditor with Shariah knowledge and background or the external Shariah auditor may determine an external Shariah supervisor (outside the control of the audited institution).

5. Underlying subject matter and criteria

Based on the ED (para 15), the criteria for assessment are the Shariah principles and rules defined by the following hierarchy, as appropriate:

- a) Shariah standards issued by AAOIFI;
- b) The regulations issued by the respective jurisdiction's regulator insofar as these entail the regulatory Shariah requirements;
- c) The rulings of the Central Shariah Board for the respective jurisdiction;
- d) Requirements of the applicable Financial Accounting Standards as issued by AAOIFI insofar as these entail Shariah related requirements;
- e) Approvals and rulings given by the Shariah Supervisory Board of the IFI.

The existing AAOIFI audit standard (no.4) indicates that the external auditor shall depend on fatwa, ruling and guidance of Shariah Supervisory Board (SSB) in considering whether IFIs have complied with Islamic Shariah rules and principles (para 8). However in this ED the SSB comes last in the hierarchy. In addition, the ED is silent on the role and position of the rulings of the International Islamic Fiqh Academy. CIBAFI encourages the need to have more clarity here, especially with the mention of the word "as appropriate" that needs to be elaborated mainly for cases where only certain Shariah Standards are adopted in the jurisdiction through the regulator.

6. Principal procedures

On the key considerations of Shariah audit process, the ED mentions the issue of materiality (para. 21 and 22), where the materiality consideration is the significance of

the matter either quantitatively or qualitatively. It then discusses how this should be interpreted for external Shariah audit. Examples of the proposed materiality considerations include the materiality in terms of amount relevant for decision making, the tolerable amount and observed rate of deviation (quantitative considerations), and the nature and cause of any observed deviation. The text notes that the considerations might be different from those in a financial audit, but the English text here is very unclear as to what is actually proposed.

However, the ED provides a chart of principle procedures to be performed by the external Shariah auditor which include 13 procedures, CIBAFI notices that the ED only provides details on some procedures while keeping silent on others. It is better to provide details related to all procedures to better understand the working nature and mechanism of external Shariah auditor, including details from Shariah point of view.

7. Relation with Shariah Supervisory Board (SSB)

The ED (para 13) indicates that “Underlying subject matter of direct external Shariah audit shall comprise “assessing compliance of the IFI’s financial arrangements, contracts, and transactions with Shariah principles and rules”. Therefore, the External Shariah Auditor has been given the right to issue their own Shariah opinions when assessing the compliance with Shariah Principles and Rules. Those opinions might be in conflict with the IFI’s SSB’s opinions which are sometimes based on long discussions, debates and different interpretations and Fatwa, which might be beyond the capacity and skills of the External Shariah Auditor.

On the other hand, The ASIFI 4 (para 17) “Making the external auditor’s report available to SSB”, indicates that “prior to issuance of the final report of SSB, the external auditor shall make available to the SSB his draft report and conclusions related to Shariah compliance”. The ED is silent on draft report to be made available to SSB prior to the issuance. CIBAFI finds that the relation between external Shariah auditor and SSB is not clear, especially on what would be the recourse/procedure in case of conflict between them.

8. Others

Some elements of the text seem to have been carried over from financial audit procedures, and it is difficult to see how they might be applied in practice to Shariah audit. For example, the ED mentions the issue of sampling (para 24), and says that to determine a sample size, the external Shariah auditor shall apply statistical approaches and judgment with regard to risk of Shariah non-compliance. The sample selection “shall be based on statistical techniques and in case of identified instances of Shariah non-compliance, the sample sizes shall be increased adequately”. It is not clear how statistical techniques might be applied in some key areas, for example, product design. Again, in para 34, the ED deals with assessing residual risk, and reducing this risk by testing details. Some of this material also seems of doubtful applicability to Shariah audit. The reference to “physical inspections” is a particularly obvious example.